No. 14775

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

Elmer J. Thompson, Helen H. Thompson,

Appellants,

vs.

Commissioner of Internal Revenue,

Respondent.

APPELLANTS' REPLY BRIEF.

Nathan J. Neilson,
412 West Sixth Street,
Los Angeles 14, California,
Attorney for Appellants.

FILED

NOV 23 1955

PAUL P. O'BRIEN, CLERK

Parker & Son, Inc., Law Printers, Los Angeles. Phone MA. 6-9171.

TOPICAL INDEX

PAGE

Summary of respondent's contentions 1

Federal law governs in determination of bad debt deduction 2

Appellant must prove absence of any relationship other than debtor-creditor 5

Failure of appellant to prove year of loss 6

TABLE OF AUTHORITIES CITED

Cases PAGE

Alexander & Baldwin v. Kanne, 190 F. 2d 153 3

Allen-Bradley Co. v. Commissioner, 112 F. 2d 333 4

Bercaw v. Commissioner, 165 F. 2d 521 4

Earle v. W. J. Jones & Son, 200 F. 2d 846 3

Inman-Poulsen Lumber Co. v. Commissioner, 219 F. 2d 159 3

Kanne v. American Factors, 190 F. 2d 155 3

Milton Bradley Co. v. United States, 146 F. 2d 541 4

Russell Box Co. v. Commissioner, 208 F. 2d 452 4

San Joaquin Brick Co. v. Commissioner, 130 F. 2d 220 ..... 3, 6

No. 14775

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

ELMER J. THOMPSON, HELEN H. THOMPSON,

Appellants,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

APPELLANTS' REPLY BRIEF.

Summary of Respondent's Contentions.

The Respondents contentions in opposition to Appellant's position, as set forth in Respondent's Brief, appear to fall within three general categories:

1. Federal Law governs in determination of bad debt deduction.
2. Appellant must prove absence of any relationship other than debtor-creditor.
3. Failure of Appellant to prove year of loss.

Federal Law Governs in Determination of Bad Debt Deduction.

Throughout the entire tax controversy herein involved, prior to, during trial, and subsequent thereto, Respondent has contended that Federal Law governed the allowance of "bad debt deductions." It is obvious from Respondent's contentions throughout that he meant to imply that Federal Law Government not only "the deduction of a bad debt" but the determination of whether a "debtor-creditor" relationship existed, and whether a debt became "bad." Further the apparent intention of Respondent in taking this position was to imply that Federal Law in this respect was different than State Law.

It is conceded that the claiming of a bad debt "deduction" is governed by the law which Respondent set forth in his Brief. (Resp. Br. pp. 2-7.) Respondent has not, however, supplied any authority to refute Appellant's contention that State Law governs in the determination of a debtor-creditor relationship.

For the first time in the entire proceedings, Respondent in his Brief sets forth his authority for his position. (Resp. Br. p. 13.) He starts by setting forth what he contends to be the general rule: "A debt, and accordingly the right to deduct its worthlessness, for federal tax purposes, is a transaction between parties intending to create *ab initio* a loan or credit situation—*i.e.,* debtor-creditor relationship in the ordinary sense—and rests upon the existence of an unconditional obligation or guarantee to repay the amount of the money advanced or credit extended." In support of this alleged rule he cites some ten Federal Court cases. Nowhere in these cases is there found any holding to support the rule as set forth

by the Respondent. The only general rule to be found in these cases is that set forth in *Inman-Poulsen Lumber Co. v. Commissioner,* 219 F. 2d 159, where the Court said, "The term 'indebtedness' as used in the act implies an unconditional obligation to pay."

Further examination of these cases reveal that they are of no help in this matter because they are based on factual situations not analogous to the instant case. In the *Inman-Poulsen Lumber Co.* case, the advances which were made as the basis for the bad debt claim were advances to a shareholder to be repaid only if, as, and when dividends were paid by the corporation. The Court held the advances were in the nature of gifts rather than bona fide debts.

In the cases of *Kanne v. American Factors,* 190 F. 2d 155, and *Alexander & Baldwin v. Kanne,* 190 F. 2d 153, the notes involved were payable only when, if and to the extent that after all the indebtedness and litigation costs of Waterhouse had been discharged, it still had assets from the sale of which all or part of the sum could be paid. These conditions were never met and the Court stated there was no certainty that they ever would be. The Court did state however:

> "If thereafter the Waterhouse Co. had become hopelessly insolvent and could not possibly have paid anything on the debt, it would have become 'bad' within the meaning of Section 23(j). That was not the case."

In *San Joaquin Brick Co. v. Commissioner,* 130 F. 2d 220, the bad debt claimed involved a loss on bonds.

In *Earle v. W. J. Jones & Son,* 200 F. 2d 846, the question was whether advances by shareholders were loans

or capital contributions. The Lower Court found they were loans. Judgment was affirmed.

In *Russell Box Co. v. Commissioner,* 208 F. 2d 452, the primary question was one of sufficiency of evidence only.

In *Bercaw v. Commissioner,* 165 F. 2d 521, the question of the bad debt pertained to the guardian's duty to repay the money in the event of a successful termination of the litigation; and that event never took place.

In *Milton Bradley Co. v. United States,* 146 F. 2d 541, the Court held that under the Statute an amount is deductible for income tax purposes as a "bad debt" where there is a valid debt arising out of a debtor-creditor relationship, and an unconditional obligation to pay. The liability to pay in the future, contingent upon something which may or may not occur, is not an indebtedness.

In *Allen-Bradley Co. v. Commissioner,* 112 F. 2d 333, the Court held that "an indebtedness" signifies an unconditional obligation to pay.

Nowhere in the foregoing is there authority for Respondent's position that a debtor-creditor relationship must be "intended" at the commencement of a transaction and not a "result" therefrom. Nowhere in the foregoing is there any support for Respondent's contention that Federal Law governs in the determination of debtor-creditor relationship.

Further, Respondent has made no showing that even if Federal Law controls in such a situation, that a debtor-creditor relationship did not arise in the instant case.

Appellant Must Prove Absence of Any Relationship Other Than Debtor-Creditor.

Respondent in his Brief states, "To overcome the Commissioner's determination, the taxpayers first had to prove that their association with Miller was not that of limited partner, or outfitter, or grubstaker in a mining venture for profit, but was, instead, that of creditor in a personal loan transaction, detached from and without interest in the mining venture. Section 23(k)(4), 1939 Code." (Resp. Br. p. 12.) He states further "The taxpayers' argument is not that they intended to establish a debtor-creditor relationship *ab initio* by virtue of their purported limited partnership agreement or joint venture in the mining business, but rather than such joint venture, or grubstake, or limited partnership arrangement somehow 'became that of debtor and creditor.'" (Resp. Br. p. 13.) And further, "Thus, the taxpayers have failed to establish a bad debt deduction. Where the clear intendment of the taxpayers was to make an investment for profit, they will not be heard to claim they merely made a loan." (Resp. Br. p. 16.)

In the instant transaction the Appellants advanced the sums involved to the said Jack Miller. No part of the money was ever recovered by the Appellants. For income tax purposes the Appellants, upon the advice of counsel, and after careful consideration, determined that they had suffered a non-business bad debt loss. They claimed this loss on their 1940 income tax return. It is axiomatic that the only thing the Appellants were required to substantiate in the Tax Court was this bad debt deduction. It makes no difference how many or what kind of relationships existed between the Appellants and the said Jack Miller.

Failure of Appellant to Prove Year of Loss.

The Appellants, in their own minds, in the year 1949 concluded, and this for the first time, that they would never recover any of the money advanced to the said Jack Miller. They claimed their bad debt loss in that year.

Much was made by the Tax Court and by Respondent in his Brief of the statement by Appellants that the debt "probably became bad sometime near the middle of the year 1947." (Resp. Br. p. 11.)

He fails apparently to distinguish between actual date of worthlessness and the date of ascertainment of that fact by the Appellants.

In *San Joaquin Brick Co. v. Commissioner,* 130 F. 2d 220, cited by Respondent, the Court held:

> "In the case of bad debts, the actual worthlessness of the debt prior to the tax year in which the deduction is claimed is immaterial so long as the debt 'is not ascertained to be worthless' by taxpayer prior to that time.
>
> "Nobody understands that this imposes upon him the absolute risk of selecting the year they actually became so."

There were two separate grounds upon which the Tax Court, had it determined that Appellants had suffered a bad debt loss, could have found the loss allowable in the year 1949:

1. Upon the ground that that was the year in which the Appellants ascertained they sustained the loss and the year in which they claimed it.

2. As a carryover either from the year 1947 or the year 1948.

Even though the "debt" from Jack Miller to the Appellants came into being at the time of the initial transactions, the Appellants could not have claimed and could not have substantiated that it became "bad" in any year prior to 1947. Appellant has on file valid and timely claims for refund, filed under seven-year Statute of Limitations, claiming the bad debt loss in each of the years 1947 and 1948. Carryover provisions are set forth in both Appellant's and Respondent's Briefs.

The Tax Court has a moral and a legal duty to assist in the proper determination of Appellant's income taxes. The decision of the Tax Court that the Appellants did not suffer a bad debt loss in the year 1949 is of no assistance whatsoever either to Appellants or Respondent as far as a determination of the validity of the aforesaid 1947 and 1948 claims are concerned. It leaves the parties no alternative but to commence proceedings all over again.

The Tax Court had before it every fact, upon which to determine the year of loss, that was available to Appellants.

November 22, 1955.

Respectfully submitted,

Nathan J. Neilson,

Attorney for Appellants.